

Office of Chief Counsel
Internal Revenue Service

memorandum

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JSRepsis

date: July 11, 2000

to: Bonnie Bledsoe, Team Manager, Group 1245, North Texas District
MC 4304 NWSAT

from: District Counsel, North Texas District, Dallas
MC 2000 NWSAT

subject: [REDACTED]

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By memorandum dated April 25, 2000, you requested Field Service Advice regarding the following issue:

ISSUE

The Internal Revenue Service conducted an examination of the alternative minimum tax for [REDACTED] for its tax period ended December 29, [REDACTED]. Subsequently [REDACTED] was merged into [REDACTED]. Currently, an audit is being conducted of [REDACTED] for its tax years ended September 30, [REDACTED] and [REDACTED] and involves the examination of carryforward losses from [REDACTED]'s tax period ended December 29, [REDACTED]. Does I.R.C. § 7605(b) prohibit an examination of the books and records of [REDACTED] in connection with the audit of [REDACTED]?

SHORT CONCLUSION

No. Section 7605 provides a general prohibition against an unnecessary second examination when an inspection of a taxpayer's books of account has already been made for a taxable year. The Service currently has under audit a different taxpayer ([REDACTED]) as well as different tax years (September 30,

██████████ and ██████████) than were involved in the audit of ██████████. Consequently, there is no second examination and the Service may request all relevant information to verify the losses claimed by ██████████ which originated with ██████████.

FACTUAL ANALYSIS

On ██████████, all of the assets and liabilities of ██████████ were acquired by the Federal Savings and Loan Insurance Corporation (FSLIC), as receiver. On this day, the stock of ██████████, as well as seven other savings and loans, was purchased by ██████████ from the FSLIC. This purchase was considered a reorganization under § 368(a)(1)(G) and ██████████ was allowed to utilize any net operating loss carryovers of the purchased savings and loans. ██████████ was, and still is, the wholly-owned subsidiary of ██████████.

██████████ has a tax year ending June 30th. Because of the reorganization, it was required to file a short-period tax return for the tax period July 1, ██████████ to December 29, ██████████ (██████████ tax year). This return was signed on ██████████ by the Federal Deposit Insurance Corporation (FDIC) (successor to the FSLIC) and subsequently filed with the Service. This return showed no tax due, but rather generated a net operating loss.

Subsequently, on ██████████, the FDIC filed an amended return for the ██████████ tax year. This amended return contained several adjustments, which resulted in a refund to the taxpayer of its alternative minimum tax.

In ██████████, ██████████ was audited for its ██████████ tax year. The Revenue Agent's Report indicates that the scope of the examination was limited to those items claimed on the amended return. From the information provided, it appears that the agent initially proposed an adjustment resulting in additional alternative minimum tax being due. Ultimately, however, a no-change letter was issued for this examination on ██████████.

Currently, LMSB Group 1245 has under examination ██████████ for its tax years ended September 30, ██████████ and ██████████ (██████████ and ██████████ tax years). One of the items being audited is ██████████'s net operating loss carryover from ██████████ which originated in the ██████████ tax year and prior tax years. The Service has requested the books and records of ██████████ for those years in which the net

operating loss originated.¹

██████████ is gathering the information, but believes that the examination is prohibited under § 7605(b) since it entails a second review of ██████████'s books and records for the ██████████ tax year. Pursuant to § 7605(b), ██████████ has requested a reopening letter before providing the requested information.

LEGAL ANALYSIS

Section 7605(b) provides as follows:

No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

Section 7605(b) imposes restrictions on two activities: (1) unnecessary examinations or investigations, and (2) more than one inspection of a taxpayer's books of account for a tax year. In construing the language of this section, courts have held that the prohibition against a second "inspection" must be read in pari materia with the opening clause of the section. As the Fifth Circuit Court of Appeals noted in United States v. Schwartz, 469 F.2d 977, 983 (1972), the first clause appears to be the original purpose for which the statute was enacted. See also United States v. Kendrick, 518 F.2d 842, 846 (7th Cir. 1975). In applying the restrictions of § 7605(b), courts have been reluctant to restrict legitimate investigations by the Service.

Section 7605(b) first appeared as § 1309 of the Revenue Act of 1921, 42 Stat. 310. Congress designed this section in response to taxpayer complaints that revenue agents were subjecting them to onerous and unnecessarily frequent examinations and investigations. See H.R. Rep. No. 67-350, at 16 (1921). The purpose of the section is to relieve taxpayers from unnecessary annoyance. 61 Cong. Rec. 5855 (Statement of Sen. Penrose) (1921).

Section 7605(b) was not, however, designed to prevent an

¹ The statute of limitations for assessment on ██████████'s tax return for the tax period ended December 28, ██████████ had expired by the time the audit of ██████████ had commenced.

agent from "diligently exercising his statutory duty of collecting the revenues." Benjamin v. Commissioner, 66 T.C. 1084, 1098 (1976). Indeed, the Ninth Circuit Court of Appeals stated in DeMasters v. Arend, 313 F.2d 79, 87 (9th Cir. 1963), that the grants of power in § 7601 (power to canvass districts) and § 7602 (power to examine books, records, etc.) "are to be liberally construed in recognition of the vital public purposes which they serve; the exception stated in § 7605(b) is not to be read so broadly as to defeat them."

The fundamental prerequisite to the application of § 7605(b) is that a second examination is occurring for the same taxpayer for the same tax year. This prerequisite does not exist in this case. The initial examination was of [REDACTED] for its [REDACTED] tax year. The current examination is of [REDACTED] for its [REDACTED] and [REDACTED] tax years. The difference in taxpayers and years is obvious.

Although a different taxpayer and tax years are under examination, the same books and records might be inspected in the examination of [REDACTED] in order to determine the validity of the net operating loss carried forward into [REDACTED] and [REDACTED].² The courts which have addressed this question have refused to find § 7605(b) applicable where a carryover from an audited tax year is utilized by a taxpayer in a subsequent tax year.

A case in point is Digby v. Commissioner, 103 T.C. 441 (1994). In Digby, the Service audited the taxpayer's 1987 tax year. Based upon estimates, it allowed a flow-through loss from an S Corporation in which the taxpayer owned an interest. A different agent audited Digby's 1988 tax return and disallowed a flow-through loss from the same S Corporation due to a lack of basis. From the documents used in the 1988 audit, the second agent also proposed to disallow the 1987 flow-through loss because of a lack of basis. A notice of deficiency was issued for both years.

In the Tax Court proceeding, the taxpayer argued that the records used to audit and adjust the 1988 tax year were the same that were needed to audit the 1987 tax year. As such, a second examination of the 1987 books and records had occurred in contravention of § 7605(b). The taxpayer requested the Court to declare the notice of deficiency invalid and to dismiss the

² We specifically do not address the issue of whether the same books and records of [REDACTED] will be examined for [REDACTED] and [REDACTED] tax years. In the present set of circumstances, we do not believe this inquiry is relevant. Furthermore, it is not clear what was examined by the agent for [REDACTED]'s [REDACTED] tax year.

action.

Judge Gerber of the Tax Court disagreed and stated:

... The precise question that arises here is whether inspecting records for a later year which results in adjustments for the earlier and already examined year constitutes a second inspection for the earlier year. Section 7605(b) concerns a second inspection for the same taxable year. Accordingly, where information is obtained by means of an examination of a later or different taxable year that affects an already examined year, it may not be a second inspection within the meaning of section 7605(b), even though the same records are inspected. (at 448).
(Emphasis added).

The Court went on to discuss that in those situations where an issue is continuing in nature, the records underlying the particular item in question would have been the same no matter which of the two taxable years was examined. For the taxpayer's contention to be sustained would require the parties to review all of the records needed for a current year's examination and then determine whether any of them had been inspected in connection with a prior year's examination. The Court held that this was not the purpose or intended result of section 7605(b). (at 449).

In conclusion the Court stated the rule it was creating:

It is clear that Congress did not intend to restrict the Commissioner from auditing subsequent years' transactions originating from the same records, even if those records had been inspected in connection with the audit of an earlier year. Although no court has previously addressed this particular variation regarding section 7605(b), we believe that the statutory meaning and intent is clear, and the circumstances here are not a second inspection of petitioner's 1987 records. Accordingly, respondent was not required to provide written notice to petitioner of the intent to conduct a second inspection. (at 450).

The present case provides a factual circumstance even stronger than that found by the Tax Court in Digby. Not only is the tax year different for this continuing issue of a net operating loss carryforward, but the taxpayer is not the same. Furthermore, [REDACTED]'s [REDACTED] tax year will not be effected since the statute of limitation on assessment bars any determination of

a deficiency for that year. As such, our office can find no application of section 7605(b) to the present case.

CONCLUSION

Based upon our review of the facts in this case, our office does not believe a § 7605(b) prohibited second inspection of a taxpayer's book and records exists in this situation. Because of this conclusion, you may request whatever documents you deem relevant to audit the correctness of the net operating loss carryforward. This would include any component of [REDACTED]'s tax year ended December 29, [REDACTED] and prior tax years that would effect the net operating loss carryforward. A reopening letter contemplated by § 7605(b) is not required.

We suggest you inform the taxpayer of our conclusion. - If the taxpayer still does not want to provide the requested books and records, we suggest the issuance of a summons to obtain the relevant records.

This document is subject to the Large Case Coordination Procedures of CCDM 35(19)4(4). Pursuant to this provision, a copy of this advice has been forwarded to the Assistant Chief Counsel for his review concurrent with the providing of this advice to you. Within ten days of receipt, the appropriate Associate Chief Counsel is required to respond regarding the advice. The response will indicate whether the National Office: (a) concurs with the Field advice; (b) believes some modification of the advice is appropriate; or (c) needs additional information or time for analysis in order to evaluate the advice. Our office will inform you of the comments received by us.

Our office will maintain its file on this case pending notification from you that it may be closed. If you should have any questions regarding this memorandum, please contact the undersigned at (972) 308-7900.

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By:

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